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SURREBUTTAL TESTIMONY OF

DAVID J. GARRETT

ON BEHALF OF

THE SOUTH CAROLINA OFFICE OF REGULATORY STAFF

DOCKET NO. 2021-324-WS

THE OFFICE OF REGULATORY STAFF
1401 Main Street, Suite 900
Columbia, SC 29201

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I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is David J. Garrett. My business address is 101 Park Avenue, Suite 1125, Oklahoma City, Oklahoma 73102.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am the managing member of Resolve Utility Consulting, PLLC. I am an independent consultant specializing in public utility regulation.

Q. DID YOU FILE DIRECT TESTIMONY AND EXHIBITS RELATED TO THIS PROCEEDING?

A. Yes. I filed Direct Testimony and 17 exhibits with the Public Service Commission of South Carolina ("Commission") on February 24, 2022, on behalf of the South Carolina Office of Regulatory Staff ("ORS"). In my Direct Testimony, I provided my estimate of the cost of capital of Kiawah Island Utility, Inc. ("KIU" or the "Company"), as well as a reasonable authorized rate of return for KIU. My qualifications were also discussed in my Direct Testimony.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. My Surrebuttal Testimony will respond to issues raised in the Rebuttal Testimony of KIU Witness Douglas H. Carlisle.

Q. DID ANY OF THE ARGUMENTS WITNESS CARLISLE RAISED IN HIS REBUTTAL TESTIMONY CAUSE YOU TO CHANGE YOUR POSITION AS STATED IN YOUR DIRECT TESTIMONY?

A. No. Additionally, to the extent I do not specifically address a statement made in any of the Company's rebuttal testimony that should not be construed as an agreement with such.

Q. HAS THE COMPANY DISPUTED YOUR RECOMMENDATION THAT KIU'S RATES BE DETERMINED UNDER A RATE OF RETURN APPROACH, RATHER THAN AN OPERATING MARGIN APPROACH?

A. No, it does not appear so. In my Direct Testimony, I proposed that KIU's rates should be determined using a return on rate base approach, rather than an operating margin approach. In reading Witness Carlisle's Rebuttal Testimony, as well as the rebuttal testimony of other KIU witnesses, it does not appear the Company opposes the use of a return on rate base approach. Thus, the primary issue at this point is not whether KIU's rates should be set based on a rate of return approach, but rather the appropriate level of that return.

Q. DO YOU THINK THE RESULTS OF ANY OF WITNESS CARLISLE'S COST OF EQUITY MODELS REFLECT A REASONABLE AUTHORIZED ROE FOR KIU?

A. Yes. Interestingly, Witness Carlisle's Discounted Cash Flow ("DCF") Model produced an indicated cost of equity of 7.74%, which is very close to the midpoint of my cost of equity range of 7.43%. In addition, the average result of Witness Carlisle's Capital

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Asset Pricing Model ("CAPM") and DCF analyses is 8.43%,[1] which is nearly identical to my authorized ROE recommendation of 8.44%. While I disagree with several aspects of Witness Carlisle's testimony and analysis, as further discussed below, an authorized ROE of either 7.74% or 8.43% could be considered reasonable in this case.

Q. PLEASE SUMMARIZE YOUR SURREBUTTAL TESTIMONY.

A. In my surrebuttal testimony, I respond to several pertinent issues discussed in Witness Carlisle's rebuttal testimony, including (1) the authorized return on equity ("ROE"); (2) the DCF Model; (3) the CAPM; (4) the Comparable Earnings Model ("CEM"); and (5) economic conditions.

II. <u>AUTHORIZED ROE</u>

Q. PLEASE SUMMARIZE WITNESS CARLISLE'S PROPOSED ROE.

A. Witness Carlisle recommends an authorized ROE of 9.35% for KIU, which is at the top end of an "inner range" of 8.43% - 9.35%.[2] According to Witness Carlisle, he is recommending the top end of his inner range "because a market correction is already underway..." regarding interest rates and inflation and he "expect[s] economic factors to make the two ends of [his] range converge over the next year or two."[3] Witness Carlisle also states: "My assessment of indicated ROE is solely for comparative purposes, however, since this is a case brought on operating margin."[4]

[1] Rebuttal Testimony of Douglas H. Carlisle, p. 37, lines 17-18.

[2] Rebuttal Testimony of Douglas H. Carlisle, p. 5, lines 10-16.

[3] *Id*.

[4] *Id*. at lines 19-21.

Q. HOW DOES WITNESS CARLISLE'S PROPOSED ROE COMPARE WITH THOSE PROPOSED IN THIS CASE AND THE AUTHORIZED ROES IN OTHER RECENT WATER/WASTEWATER CASES IN SOUTH CAROLINA?

A. Witness Carlisle's recommended ROE of 9.35% for KIU is notably higher than both my proposal and that of Department of Consumer Affairs ("DCA") Witness Aaron Rothschild in this case. Witness Rothschild proposes an ROE of 7.47% (the midpoint in a range of 6.78% - 8.16%),[5] and I propose an ROE of 8.44% (the top end of an estimated cost of equity range of 6.43% - 8.44%). Witness Carlisle's proposed ROE is higher than the ROE approved by the Commission in the recent rate case filed by KIU's sister company, Palmetto Water Reclamation, Inc. ("PWR"), where the Commission authorized an ROE of 8.0%.[6]

Q. IS THE RISK PROFILE OF KIU MATERIALLY DIFFERENT THAN THAT OF ITS SISTER COMPANY, PWR?

A. No. I also provided ROE testimony on behalf of ORS in PWR's recent rate case before the Commission. In that case, I estimated a cost of equity range of 6.3% - 8.0% for PWR based on the CAPM and DCF results, respectively. In this case, I estimate a cost of equity range of 6.43% - 8.44% for KIU based on the CAPM and DCF results, respectively. The cost of equity ranges have slightly increased between these two cases due to the

[5] Direct Testimony of Aaron L. Rothschild, p. 4, lines 17-21.

[6] Docket No. 2021-153-S, Order No. 2021-814; PWR is a sister utility to KIU under the SouthWest Water Company corporate umbrella.

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increase in Treasury bond yields.[7] In the PWR case, the Commission authorized an 8.0% ROE, which was equal to the top end of my cost of equity range in that docket. Likewise, I recommend the Commission authorize an ROE of 8.44% in this case, which is the top end of my cost of equity range. If the Commission decides to authorize an ROE other than 8.44%, the ROE should be lower as there is evidence indicating that KIU's market cost of equity could be lower than 8.44%. In fact, the average of my DCF and CAPM results indicates a cost of equity of 7.43% for KIU. Despite the issues raised in Witness Carlisle's testimony, I do not believe there is any convincing evidence indicating that KIU's cost of equity would be higher than 8.44%.

III. DCF RESULTS

Q. PLEASE SUMMARIZE WITNESS CARLISLE'S DCF RESULTS.

A. Witness Carlisle's DCF analysis indicates a cost of equity of 7.74%.[8]

Q. IN TERMS OF A COST OF EQUITY ESTIMATE, DO YOU THINK WITNESS CARLISLE'S INDICATED COST OF EQUITY UNDER THE DCF APPROACH IS REASONABLE?

A. Yes. A cost of equity estimate of 7.74% is only 31 basis points higher than my average cost of equity estimate of 7.43% for KIU. While I understand that Witness Carlisle is not recommending an authorized ROE that is equal to his DCF result, an authorized ROE

[7] In Docket No. 2021-153-S, my analysis of a then-recent 30-day average of Treasury bond yields indicated a risk free rate of 1.91%. In this case, my analysis indicates a risk free rate of 2.06%, which I use in my CAPM (see Exhibit DJG-8).

[8] Rebuttal Testimony of Douglas H. Carlisle, p. 6, lines 1-2.

of 7.74% would be reflective of the midpoint of my estimated cost of equity range for KIU and reasonable for the Company in this case.

Q. CAN YOU EXPLAIN THE DIFFERENCE IN WITNESS CARLISLE'S DCF RESULTS AND YOUR DCF RESULTS?

A. Yes. The difference in our DCF results is primarily related to the growth rate input. Estimating a long-term growth rate input for water utilities in the current market is challenging in terms of assessing the low dividend yield of water utilities in relation to their growth opportunities. For companies in general, I believe that long-term GDP growth should be viewed as a limiting factor on long-term earnings growth. Indeed, if a company's annual earnings growth rate exceeded annual GDP growth every year, then theoretically its earnings would eventually surpass GDP. This scenario, however, is effectively impossible. For those reasons, one could argue that the long-term growth rates used by Witness Carlisle and myself are both higher than what could be considered sustainable over the long run. However, using a growth rate capped by long-term GDP growth would arguably produce an unreasonably low cost of equity estimate given the relatively low dividend yields of the proxy group in the current market environment. Thus, analysts must select the most appropriate growth rate based on their judgment in consideration of all these factors. While Witness Carlisle's DCF result of 7.74% is notably lower than my result of 8.44%, I do not believe Witness Carlisle's DCF result is unreasonable.

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IV. CAPM RESULTS

Q. PLEASE SUMMARIZE THE RESULTS OF WITNESS CARLISLE'S CAPM.

A. Witness Carlisle estimates a CAPM cost of equity of 9.6%, which is significantly higher than my CAPM estimate of 6.43%.[9]

Q. DO YOU THINK WITNESS CARLISLE'S CAPM RESULT REPRESENTS A REASONABLE COST OF EQUITY ESTIMATE FOR KIU?

A. No. The primary factor impacting the discrepancy between Witness Carlisle's and my CAPM results is the equity risk premium ("ERP") input. Witness Carlisle assumes an ERP of 8.7%,[10] whereas I used an ERP of 5.6%.

Q. DO YOU THINK WITNESS CARLISLE'S ERP ESTIMATE OF 8.7% IS REASONABLE?

A. No. Witness Carlisle's ERP estimate is based on a historical calculation that considers data dating back to 1926.[11] While looking at this historical data might be a useful exercise for other types of analysis, it does not represent an accurate estimate of the current and forward-looking ERP, which is the pertinent input required for the CAPM. I described in my Direct Testimony the limitations of using a historical ERP.[12] In summary, there is ample evidence suggesting that the forward-looking ERP is much lower than the historical ERP due in part to "survivorship bias," which is the tendency for failed companies to be

[9] Rebuttal Testimony of Douglas H. Carlisle, p. 6, lines 1-2.

[10] *Id*. at p. 33, lines 3-6.

[11] Rebuttal Testimony of Douglas H. Carlisle, Exhibit DHC-15.

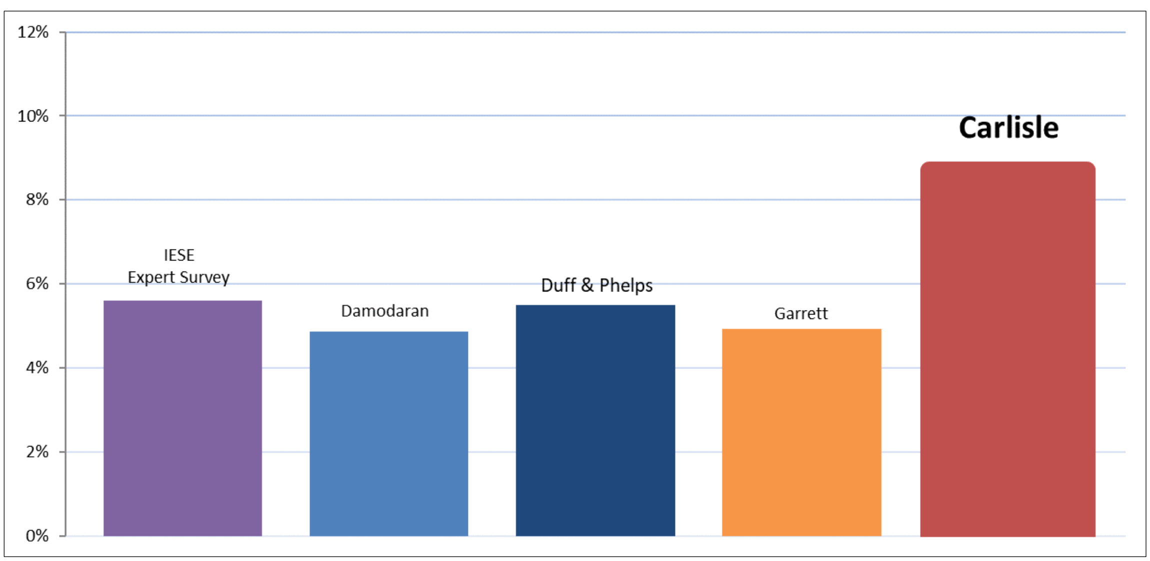
[12] Direct Testimony of David J. Garrett, p. 51, line 12 through p. 53, line 15.

excluded from historical analysis. This analytical flaw is compounded the farther back in time the historical analysis goes, which in Witness Carlisle's case, predates the Great Depression.

Q. PLEASE REITERATE THE SOURCES YOU RELIED UPON IN ESTIMATING A REASONABLE ERP.

A. In contrast to Witness Carlisle's approach, I relied on a survey of thousands of unbiased experts in helping develop a reasonable estimate for the ERP. I also looked at the estimate published by Duff & Phelps (a respected, international corporate advising firm) and the estimate published by one of the world's leading experts on the ERP – Dr. Aswath Damodaran. The *highest* ERP from these sources is 5.6% (notably lower than Witness Carlisle's 8.7% estimate). In my CAPM, I used the *highest*, of the foregoing ERP estimates, which, all else held constant, produces a higher CAPM cost of equity result. The figure below compares the various ERP estimates I have discussed.

Figure 1:
ERP Comparison



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As shown in this figure, Witness Carlisle's historical ERP estimate dating back to 1926 is unreasonably high when compared with current ERP estimates. As a result, Witness Carlisle's CAPM cost of equity estimate is unreasonably high.

V. COMPARABLE EARNINGS MODEL

Q. PLEASE SUMMARIZE WITNESS CARLISLE'S COMPARABLE EARNINGS MODEL.

A. According to Witness Carlisle, the Comparable Earnings Model ("CEM") "seeks to find similarly situated companies and infers earnings from the trends among those companies."[13] Witness Carlisle also acknowledges the "CEM has no specific methodology."[14] Witness Carlisle's CEM produced a result of 9.11%, which is nearly 70 basis points higher than my highest cost of equity estimate.

Q. DO YOU AGREE WITH WITNESS CARLISLE'S CEM ANALYSIS?

A. No. The CEM is not a cost of equity model; thus, it does not indicate a reasonable cost of equity for KIU. In contradiction to the title of Witness Carlisle's model (i.e., "comparable earnings"), it does not appear he analyzed the *earnings* of any company. Furthermore, the group of companies he analyzed are not *comparable* to KIU when compared with the utility proxy group. To the extent Witness Carlisle did consider any actual earnings as part of his CEM analysis, this approach would not produce a cost of equity estimate. This is because the earned return of a company during a period of time is

[13] Rebuttal Testimony of Douglas H. Carlisle, p. 28, lines 11-2.

[14] *Id*. at line 13.

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not necessarily related to its cost of equity. In other words, earned returns and cost of equity are two different concepts.

For example, we might conduct a cost of equity analysis on Walmart's stock and determine that, based on the risk inherent in that investment, we should "expect" a 10% return on our investment (i.e., the cost of equity from Walmart's perspective). Suppose that Walmart, however, has a bad year and only "earned" a 5% ROE. This does not mean that going forward investors now "expect" a return of only 5% on an equity investment in Walmart. Likewise, the same would be true if Walmart had a good year and earned a 20% return. In finance, the "expected" return on equity from an investor's perspective (which is synonymous with the "cost" of equity from the company's perspective) is simply based on the risk inherent in that investment and is not directly influenced by the company's actual, earned return for any given period of time.

Another problem with Witness Carlisle's comparable earnings approach is that it uses the earned returns of non-regulated, non-utility companies as an indication of KIU's cost of equity. Witness Carlisle states that "[t]o ensure comparability, I chose companies comparable to my Proxy Group" that "were not regulated utilities…."[15] This sentence alone highlights one of the primary problems with the CEM when applied to non-utilities: it is <u>not</u> comparable when compared with any analysis done on a proxy group of utility companies. Despite the title of Witness Carlisle's model, competitive, non-utility companies are decisively incomparable to KIU. If we did not have a comparable group of

[15] Rebuttal Testimony of Douglas H. Carlisle, p. 28, line 21 through p. 29, line 1.

utility companies available for analysis, then perhaps conducting DCF or CAPM analyses on a group of non-utilities might be useful. However, since we have a proxy group of comparable utilities on which to conduct our analyses, the CEM conducted on a group of non-utilities adds no marginal value in estimating a reasonable cost of equity for KIU.

VI. ECONOMIC CONDITIONS

Q. PLEASE SUMMARIZE WITNESS CARLISLE'S TESTIMONY REGARDING ECONOMIC CONDITIONS AND ITS RELATIONSHIP TO THE ROE.

A. According to Witness Carlisle, the cost of equity is likely to increase due to inflation and rising interest rates. Witness Carlisle concludes that because of these conditions, the Commission should select the upper end of his cost of equity range for KIU's authorized ROE.

Q. DO YOU AGREE THAT CURRENT OR PROJECTED ECONOMIC OR MARKET CONDITIONS WOULD JUSTIFY AN AUTHORIZED ROE FOR KIU THAT IS HIGHER THAN YOUR RECOMMENDED ROE?

A. No. Witness Carlisle provides a detailed discussion about inflation, interest rates, and even population.[16] However, the evidence he provides would not lead one to reasonably conclude that the cost of equity of KIU should be higher than 8.44%. Again, there is much more evidence indicating that a reasonable cost of equity for KIU would be lower than 8.44%. For example, Witness Carlisle notes that the Federal Reserve's plans to

[16] Rebuttal Testimony of Douglas H. Carlisle, pp. 38-43.

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increase interest rates would likely have an increasing effect on 30-year Treasury bonds – a metric which is used as a proxy for the risk-free rate in the CAPM. However, even if Treasury bond yields moderately increase in the near future, the effect on the CAPM would likely not be enough to cause it to be higher than my DCF result (and, subsequently, authorized ROE recommendation) of 8.44%. In fact, even if the yield on Treasury bonds increased an additional 150 basis points (to about 4%), the results of the CAPM would still not exceed the DCF (8.44%).

Q. WILL YOU UPDATE YOUR SURREBUTTAL TESTIMONY BASED ON INFORMATION THAT BECOMES AVAILABLE?

A. Yes. ORS fully reserves the right to revise its recommendations via supplemental testimony should new information become available not previously provided by the Company, or other sources, becomes available.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes.

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